REVIEW & OUTLOOK

Trade Deficit Bogeyman

As bogeymen go, the trade deficit is the biggest hit since "Jaws." The balance of trade is one of the least understood statistics on the economic horizon, perhaps because it is one of the least important. Normally no one needs to understand the trade balance; it's better to forget it. But at the moment the trade deficit is at the center of a lot of protectionist babble that may talk us into a new Smoot-Hawley Tariff and a new Depression, so we had better spend a few moments explaining it.

For openers, what happens if a country runs too big a trade deficit? Its currency falls. So if we continue to run a big trade deficit, the dollar will fall. But everyone on six continents thinks the dollar is too high. If it falls, everyone ought to be happy. A lot of folks have a notion that if the dollar falls, exports will rise and imports will decline, and that the Europeans will not need to keep up interest rates. So why is everyone complaining about the trade deficit? Anyone who wants a lower dollar should be rooting for a bigger deficit.

Some of the wisest words on this subject were uttered by a Treasury advisorycommittee that studied the international accounts back in 1976: "The words 'surplus' and 'deficit' should be avoided insofar as possible," it wrote. "These words are frequently taken to mean that the developments are 'good' or 'bad' respectively. Since that interpretation is often incorrect, the terms may be widely misunderstood and used in lieu of analysis."

Toying With Depression

The trade deficit is one entry in an accounting identity. By definition, the international accounts must balance. When an American spends a dollar on Hong Kong-made chopsticks, the dollar doesn't vanish. The chopstick maker only wanted it so he could buy something. Eventually the dollar will come back to the U.S. Where it shows up in the international account depends upon what the chopstick maker decides to buy.

The dollar shows up in the merchandise trade balance, for instance, if the chopstick maker uses it to buy U.S. soybeans for his tofu. It would also show up in merchandise trade if he used it to buy Oregon timber to chop into chopsticks or Alaskan oil to run the chopping machine, but he can't spend it on those commodities, since the same Congress that's in a panic over the trade deficit has outlawed their export.

If the chopstick maker uses his dollar to buy a hotel room in San Francisco or a blueprint from Bechtel, it shows up in the current account, which includes not only goods but services. If he uses his dollar to buy a share of IBM or a Treasury bond, it doesn't show up in the trade balance at all; it shows up in the investment account of the balance of payments.

The whole panic over the trade deficit is a panic over which account the chopstick maker's dollar shows up in when it comes back to the U.S. We wonder how many of the congresspeople lamenting the trade deficit even know which account they are talking about.

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The government used to issue a confusing plethora of international accounts—a "net liquidity balance," for instance. Then it made the opposite mistake of emphasizing only the trade account, leading congresspeople and others to think only trade counts.

A zero trade balance is not normal or even desirable. The U.S. ran a trade deficit for nearly all of its first 100 years, and generated trade surpluses under Smoot-Hawley in the midst of the Great Depression. Normally, a rapidly growing economy will demand more of the world's supply of real resources and run a trade deficit. It will also provide attractive investment opportunities and attract capital inflows. In a healthy world, the two will offset each other, for periods of perhaps a century.

The trouble comes when voluntary trade is not offset by voluntary investment flows. Then the international accounts have to balance through official financing, exchanges among central banks. In the international accounts, it has always seemed to us, the bottom line is not the trade deficit but the official financing.

The sensible concept is this: the trade account, the capital account and official financing, the three of which must by definition total zero. In 1977, for example, the trade account ran a deficit of $15.2 billion. The capital account ran a deficit of $13.4 billion, as investors fled the dollar. With trade and capital accounts falling apart at once, official financing had to jump to $28.7 billion, a sign of sure trouble. (This was detailed in these columns in "A Dollar Primer," Aug. 14, 1978.) The basic problem back in 1977 and 1978 was that the Federal Reserve was creating too many dollars. This was corrected with the appointment of Paul Volcker in August 1979. With a tighter monetary policy, investors moved back into dollar securities and the capital account recovered.

In 1984, the deficit in the balance on current account jumped to $101.5 billion. But foreigners made large purchases of dollar securities and U.S. banks stopped lending abroad, leading to net capital inflows of $101.3 billion. Official financing was negligible. In short, the mounting trade deficit has been amply offset by voluntary capital flows. Therefore the dollar has not declined, as a large trade deficit would normally suggest. The system is working fine despite the trade deficit—indeed, because of it.

Since the bogeyman's usual threat is so obviously not coming true, someone has had to invent some new ones. We hear worries about being in debt to foreign countries and going the way of Argentina or Mexico. But there is a big difference: the Argentine and Mexican debts were denominated in dollars while the U.S. foreign debt is denominated in dollars. So long as the debts are in our own currency, it doesn't matter where they are held or to whom they are owed.

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We hear worries about exporting jobs, though this is about the only economy in the world that is creating jobs. We hear worries that the trade deficit will continue while the capital inflows suddenly stop; this worry we hear even from Paul Volcker, the man whose policies control whether it will ever happen.

So let us give you our own interpretation of the international accounts: They reflect Chairman Volcker's success in controlling inflation and President Reagan's success in stimulating recovery in the real economy. Mr. Volcker's tight monetary policy makes the dollar the currency of choice for investors the world over; this leads to capital inflows. The advent of Mr. Reagan's supply-side tax cuts—delayed until Jan. 1, 1983—set off a U.S. boom that needed a disproportionate share of the world's resources; this leads to a trade deficit. And it also increases the capital inflows, since it makes U.S. investments even more attractive, given the stubborn refusal of European and most other nations to imitate the successful U.S. policy mix.

It all happened once before. Back in the 1920s, Andrew Mellon and Calvin Coolidge took a lot of heat for what would now be called supply-side tax cuts, while Benjamin Strong kept money tight enough to keep prices stable and even declining. But England declined to repeal its wartime tax rates, and Germany embarked on austerity. Protectionist sentiment exploded in the U.S. Congress, both the capital account and the trade account collapsed, and the Roaring '20s turned into the Great Depression.

It could happen again, if we get scared by the bogeyman. When you hear him rustle, remember this: It isn't that capital inflows are needed to offset the trade deficit. Rather, the trade deficit is essential to offset the capital inflows. If we grow while other countries insist on stagnating, we will suck in all the investment in the world. And if we refuse to recycle these investments in trade, we will be starting a spiral into the abyss.